United States Court of Appeals

for the Second Circuit

APPELLANT'S SUPPLEMENTAL BRIEF

75-7503

United States Court of Appeals
FOR THE SECOND CIRCUIT

SUSAN TANNENBAUM,
Plaintiff-Appellant,

—against—

ROBERT G. ZELLER, *et al.*,
Defendants-Appellees.

SUPPLEMENTAL BRIEF FOR PLAINTIFF-APPELLANT

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Plaintiff submits this supplemental memorandum in response to the brief submitted by the Securities and Exchange Commission ("SEC"), amicus curiae.

Preliminary Statement

Notwithstanding its thorough examination of the development of reciprocal brokerage practices in the mutual

fund industry and of its response to those developments, the brief submitted by the SEC sheds little light on the legal issues presented in this action.

First, the SEC expressly disclaims (page 20, fn. 24) that it is taking a position on the merits of any of plaintiff's claims arising under the common law (viz., breach of the adviser's fiduciary obligation to the Fund under the common law, breach of the adviser's management and distribution agreements with the Fund and breach of relevant provisions of the Fund's charter respecting sales of Fund shares). Furthermore, the SEC also disclaims taking any position on the merits of plaintiff's claims arising under the disclosure provisions of the federal securities laws.*

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* Although not mentioned in footnote 24, the SEC presumably also takes no position on the merits of plaintiff's claims of breach of fiduciary obligation arising under Rule 10b-5. In its most recent decision on recapture in an adjudicative context (Matter of Arthur Lipper Corp., Release No. 34-11773, October 24, 1975) the Commission unanimously held (Commissioner Pollack not participating) that the adviser of a fund, having utilized its power to allocate brokerage to benefit itself rather than the Fund, violated a fiduciary obligation arising under Rule 10b-5.

Second, having narrowed its focus to the single issue of the nature of the fiduciary obligations of mutual fund directors to recapture excess commissions under Section 36 of the Investment Company Act, the SEC inexplicably misconceives the issue presented in this case. Contrary to the extensive presentation embodied in Point A of the SEC's brief (pp. 21-37), it has never been plaintiff's contention that Section 36 (or Section 36(a), as amended) removes the question of recapture as a matter of statutory law from the ambit of directors' discretion. To the extent that the SEC has chosen to deal with that point, it has directed its attention, for reasons best known to itself, to an argument not made by any party in this litigation.

To the extent that the SEC's brief deals with the proper exercise of discretion by the directors under Section 36 (as opposed to the existence *vel non* of such discretion under the statute), we respectfully submit that its analysis is irrelevant, for two reasons: first, because its analysis assumes in substantial measure a state of facts not present in this case; second, because the exercise of discretion by the board is not

material to a consideration of the liability of the adviser for outright self-dealing, a circumstance indisputably present in this case. For the reasons hereinafter stated, we respectfully submit that, even if this Court should conclude, in agreement with the SEC, that Section 36 does not proscribe as a matter of statutory law the exercise of discretion by the board - a point on which we take no position, defendants are nonetheless liable to the Fund for breach of fiduciary obligation under Section 36, under Rule 10b-5 and under well-settled principles of the common law.

Argument

The central issue in this case, we submit, is whether or not M&D, the Fund's adviser, can lawfully retain the substantial profits (estimated to be several million dollars) which accrued to its direct benefit as a result of the failure of the Fund's board to utilize its power to allocate Fund portfolio brokerage in a manner which would maximize the benefits to the Fund from that resource.

To the extent that the SEC focuses its atten-

tion in its brief on (a) the competitive need to use excess commissions to pay non-executing broker-dealers, (b) the value of the services rendered to the Fund by these broker-dealers, and (c) the wisdom or lack of wisdom of utilizing excess commissions for reciprocal purposes, its analysis of the issues is fundamentally defective. Let us assume, for the sake of argument, the affirmative of each of those points: (1) competition in the marketplace required that excess commissions be used to reward broker-dealers for selling Fund shares and providing research services; (2) these services had value to the Fund (even if they also had value to the adviser); and (3) use of excess commissions for these purposes was desirable from the Fund's point of view. The question remains whether M&D, which stood in a fiduciary relation to the Fund and had a contractual obligation to the Fund to provide these same services at its own expense, could profit from a studied policy of inaction on the part of the Fund's directors. The answer at common law and under Rule 10b-5, we submit, is emphatically no, and there is no reason to suppose

that Congress intended the fiduciary standard under Section 36 to be any less demanding.*

The SEC's analysis of that question suffers from a singular flaw. Throughout its brief the SEC assumes, erroneously, that the directors had only two possible alternatives with regard to recapture, either: (a) to direct the payment of excess commissions to non-executing brokers as compensation for their services or (b) to direct that those commissions be paid to Eberstadt and applied as a credit against the advisory fee. Implicit in that assumption, is a second, equally faulty, assumption that pervades the SEC's brief, namely, that the directors were unable to secure any economic benefit

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*Even if the answer to that question were affirmative, there would then come into play the disclosure question: Assuming the adviser could lawfully profit from the directors' inaction, was there not an obligation on the part of the adviser and the directors to disclose fully to the shareholders (a) that the adviser had substantial contractual obligations to the Fund that were being discharged by use of excess portfolio commissions, (b) that there were lawful means by which those commissions (or their dollar equivalent) could be applied for the Fund's benefit and (c) that the directors had determined not to take any action that would result in recovery for the Fund of those dollars? The failure to disclose these facts, we submit, is unlawful and indefensible.

for the Fund from its portfolio brokerage without sacrificing the services which were being purchased from non-executing brokers through the allocation of portfolio brokerage. In fact, the directors were not confronted with any such Hobson's choice; if they had acted with undivided loyalty to the shareholders' interests, they could have obtained <u>both</u> the services <u>and</u> the economic benefits obtainable from the portfolio brokerage.

The Fund's management and distribution agreements with M&D provided the Fund with a powerful lever which, in the hands of directors acting with singular devotion to the shareholders' interests, could have been utilized to extract significant benefits for the Fund without compelling the Fund to forego the services being purchased from non-executing broker-dealers through the allocation of portfolio brokerage. All that was required was the will to do so. Since those agreements provided that M&D would bear all costs of selling Fund shares and providing research and statistical services, the directors could have - and should have - demanded a <u>quid pro quo</u> from M&D for permitting M&D to discharge its own

obligations through the use of Fund portfolio brokerage to compensate non-executing brokers. Certainly no prudent business man would permit his own assets to be used by another party to discharge that other party's contractual obligation to himself without demanding some recompense. Yet the failure of the Fund directors to make any effort to extract any benefit from M&D had exactly the same result. Fund portfolio brokerage - amounting to millions of dollars - was allocated to non-executing broker-dealers to pay for services that M&D was contractually obligated to provide for the Fund at its own expense.* If the directors determined in their business judgment that the use of Fund portfolio broker-

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*For purposes of this analysis, it has been assumed that these services, viz., sales of Fund shares and research and statistical services, were of value to the Fund. So far as the promotion of sales is concerned, we share the doubt expressed by the Burgin court (445 F.2d at 374) and by the SEC in its brief (pp. 6, 52) that increased sales benefited anyone other than the adviser/distributor. Every share sold by a dealer not only resulted in an underwriting commission to M&D but also enlarged the asset base upon which M&D's fee as adviser was computed. While various rationalizations have been offered by members of the industry from time to time to demonstrate that increased sales benefited the Fund, the alleged benefits have always proved to be speculative and conjectural. The immediate, direct benefit to the adviser/distributor from increased sales, however, is and has always been both measurable and substantial.

age for reciprocal purposes should not be disturbed, nonetheless, as prudent businessmen, required by law to act solely in the best interests of the Fund, they had an obligation to obtain from M&D some quid pro quo for M&D's use for its own benefit of a substantial resource of the Fund.

It is not disputed that prior to the abolition of "give-ups" on December 5, 1968, recapture of excess commissions for the benefit of the Fund could be effected through bookkeeping entries and did not require any participation by Eberstadt or M&D in the execution of portfolio transactions. The SEC has pointed out (p. 14, nf. 15) that even after the abolition of "give-ups", similar recapture techniques remained available. Of course, use of any of these techniques would have deprived broker-dealers providing sales and other services of Fund portfolio commissions and would have required that some other means be found to compensate them for their services. Under the Fund's management and distribution agreements, however, M&D, not the Fund, had the obligation to provide and pay for these services. Assuming that the directors considered it advantageous to continue to receive these services and believed it necessary or desirable that

these broker-dealers be paid by means of allocations of portfolio commissions, nonetheless there was no compelling necessity that the cost burden be made to fall on the Fund. Among other things, the Fund's directors, if they had been so inclined, could have insisted that M&D compensate the Fund by a direct credit against the advisory fee as the price for permitting M&D's contractual obligations to be satisfied by the allocation of portfolio brokerage to these broker-dealers. Or, as another alternative, the directors could have demanded that M&D, in exchange for being relieved, in whole or in part, from its obligation to pay all costs of sales and other services, negotiate management and distribution agreements more favorable to the Fund. Numerous other alternatives were available which, if pursued, would have conferred substantial economic benefits on the Fund without in any way diminishing the quantity and quality of the services being received from broker-dealers.

The record in this action is devoid of any evidence that the Fund directors ever made any effort to obtain for the Fund any compensation from M&D in consideration of its being relieved of the burden of its

substantial and potentially costly contractual obligations to the Fund or that they ever attempted to enforce in any other way the Fund's contractual rights under the management and distribution agreements.

In fact, the available proof shows just the contrary. The directors of the Fund, acting in conjunction with M&D, repeatedly sought ways to avoid having to recapture excess commissions for the benefit of the Fund. At each stage of the evolution during the 1960's of the law governing recapture the directors actively explored with M&D and its counsel, Sullivan & Cromwell, possible means of evading the increasingly apparent legal imperative that excess commissions be recaptured for the benefit of the Fund. In 1968, in response to proposed Rule 10b-10, they obtained the Sullivan & Cromwell opinion letter (Exh. 75). In 1971, in response to the Court of Appeals decision in Burgin, they explored with the adviser and its counsel the possibility of circumventing that decision by amending the Fund's charter (Exh. 77, para. 5). In 1972, immediately after the denial of defendants' petition for writ of certiorari in the Burgin case, the directors caused the adoption of

an amendment to the Fund's certificate of incorporation "to make explicit that which has always been implicit. ." (Exh. 35). Predictably, there is not one shred of evidence in the record to show that the directors ever placed themselves, either practically or conceptually, in an adversary posture vis-a-vis M&D or ever asked themselves how they could enlarge the benefits to the Fund (necessarily at the expense of M&D) arising from the Fund's ability to control the allocation of portfolio brokerage.

In its brief the SEC has already expressed its view, based on large experience, that "non-affiliated" directors are rarely ever truly independent of domination by the adviser (p.37), and there is nothing in the record in this case to suggest that the Fund's "non-affiliated" directors, all of whom were at all times nominees of management, rose above the usual level of complacency.

Eberstadt and its predecessor partnership. F. Eberstadt & Co., had been a broker-dealer firm for many years, long before the formation of the Fund itself. Sometime prior to 1965, Eberstadt, which had become a member firm of the New York Stock Exchange in 1962, formed M&D as a wholly-owned subsidiary, and thereafter

the Fund's management and distribution functions were administered through M&D. Like most mutual funds, the Fund itself was a complete captive of its adviser and, except for its securities holdings, was nothing more than a corporate shell. All its officers were also officers of M&D, who in turn were officers and directors of Eberstadt, the parent company. The Fund, of course, observed at all times the statutory requirement under the Investment Company Act that it have a board of directors a majority of whom were "non-affiliated", but the Chairman of the Board was at all times a senior executive of Eberstadt; the "non-affiliated" directors were at all times management nominees; and the Fund apparently never had any legal counsel other than Sullivan & Cromwell, the firm which routinely represented M&D and Eberstadt. It is hardly surprising that the "non-affiliated" directors never once took any action inimical to the interests of Eberstadt and M&D, even to the extent of seeking independent legal advice in a complex and emerging area of the law where the conflict of interest between the Fund and its adviser was intense.

In its brief the SEC purports to find significance in the alleged full disclosure of the material facts to the Fund's "non-affiliated" directors (pp.38ff.). In the context of this case, however, such disclosure is meaningless. As the record shows, these directors repeatedly demonstrated an unwillingness to pursue or even consider any course of action that was contrary to the interests of M&D, and at each critical turn they looked for guidance and advice solely to M&D's own counsel. Disclosure to the "non-affiliated" directors under those circumstances is tantamount to no disclosure at all. Cf. Schoenbaum v. Firstbrook, 405 F.2d 200,211-212, reversed in part on other grounds en banc 405 F.2d 215 (2d Cir. 1968), cert. denied sub nom. Manley v. Schoenbaum, 395 U.S. 906 (1969); Matter of Arthur Lipper Corp., supra, p.11, fn.27.

Finally, we do not understand the SEC to contend that M&D, Eberstadt and Zeller should escape liability in this case, notwithstanding its conclusion that business judgment is available under some circumstances as a defense to a claim of breach of fiduciary duty arising under Section 36. At page 29 of its brief the SEC

notes that "looting or waste of corporate assets" would operate as limitations on the exercise of discretion by a fund's directors at common law, and it does not suggest that the same limitation would not also be applicable under Section 36. Moreover, later in its brief (p.36, fn.46) the SEC went on to stress that, even in the area of recapture, certain matters are not within the proper ambit of the board's discretion. It points with particularity to the situation where excess commissions are paid directly to the adviser or its affiliate. According to the SEC, "Fiduciary principles would have required that the excess commissions be returned to the Fund." (p.36, fn.46)

The infirmity in the SEC's brief is its failure to recognize that the conduct of defendants in this case had functionally the same effect as if they had caused excess commissions to be paid directly to M&D. Though the Fund received sales and other services from broker-dealers, the cost of acquiring these services was borne by the Fund, contrary to the provisions of the management and distribution agreements, and benefits which might otherwise have been obtained by the Fund through its

power to control the allocation of portfolio brokerage were conferred on M&D rather than the Fund. Under those circumstances, fiduciary principles arising under Section 36, no less than those arising under Rule 10b-5 and at common law, require that profits obtained by the adviser at the expense of the fund be repaid to the fund. *Cf.* *Moses v. Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied sub nom.* *Johnson v. Moses*, 404 U.S. 994 (1971).

CONCLUSION

For the reasons stated herein and in our earlier briefs, this Court should reverse the judgment entered in the District Court and should direct that judgment be entered for plaintiff.

Dated: New York, New York
May 20, 1976

Respectfully submitted,

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Of Counsel

THE UNIRTED STATES COURT OF APPEALS FOR THE DECONS CIRCUIT

TANNENBAUM

V

S

ZELLER

State of New York, County of New York, ss.:

RAYMOND BRADDICK , being duly sworn deposes and says that he is agent for Arbraham J. Brill, the attorney for the above named plaintiff-appellant herein. That he is over 21 years of age, is not a party to the action and resides at 8 Mill lane, Levittown, NY

That on the 20th day of May, 1976, 19 , he served the within supplemental brief for plaintiff-appellant

upon the attorneys for the parties and at the addresses as specified below

Sullivan & Cromwell, 48 Wall Street, NY, NY

Walsh & Frish, 250 Park avenue, NY, NY

The Securitite s and Exchange commission, Washington , D.C. 20549

by depositing two copies to each of the same securely enclosed in a post-paid wrapper in the Post Office regularly maintained by the United States Government at 90 Church Street, New York, New York directed to the said attorneys, for the parties as listed above at the addresses aforementioned, that being the addresses within the state designated by them for that purpose, or the places where they then kept offices between which places there then was and now is a regular communication by mail.

Sworn to before me, this 20th
day of May, 1976, 19

Roland W. Johnson
ROLAND W. JOHNSON,
Notary Public, State of New York
No. 4509705
Qualified in Delaware County
Commission Expires March 30, 1977

Raymond Braddick